MUNICIPAL BOND BANKS

Potential Applications in Macedonia

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This report reviews potential applications of the "bond-banking"(or pooled-borrowing) concept to local government capital financing in Macedonia. The basic idea developed in this report is that a financial intermediary, a "bond bank" or "fund," is used by these governments to access the credit markets. A bond bank may take a variety of institutional forms and perform many chores in accomplishing this objective. The kernel of the idea, however, is that the entity acquires funds in the credit markets that it, in turn, re-lends to participating localities. The intermediating role between local governments and the markets performed by a bond bank may be an end in itself. But it also can be thought of as a stepping stone to the larger goal of developing domestic financial markets that can act as a sustainable means of financing the capital needs of local governments.

Summary of Advantages

The bond-bank concept has several merits, especially for emerging and transitioning economies that possess many small and unsophisticated local governmental units, and where private-sector financial institutions have little or no experience in dealing with them. While conditions are diverse and approaches need to be tailored to specific circumstances, the global problems are reasonably comparable across country borders and are not unlike those found in even more-advanced economies. Small, infrequent borrowers present special problems in accessing credit markets that can entail relatively high costs for both the borrowers and the investors. By the same token, the assembly and pre-screening of potential borrowers, the use of standard procedures and documentation, flexibility in design available with larger-sized borrowings, and the use of portfolio concepts in providing security can bring substantial economies to the process.

Summary of Advantages

Using bond banks and pools to finance local government credit needs in transitioning and developing economies can have the following advantages:

- They can consolidate many smaller loans into a size that is more readily marketable and adaptable to the credit markets.
- They can help to make uniform the loan documentation and processes and the forms of pledged security.
- There are economies of scale in financial transactions that can lower the cost per unit of amounts borrowed.
- They can provide a central and logical point for the application of credit enhancements, either to their own securities and/or the underlying portfolio.
- They can provide, usually as a derivative of their financing activities, technical assistance and training and act as a logical focal point for its application.

Characteristics

Although the expression "bond bank" is used in this report, the intermediary need not be a "bank" nor is it necessary that it deal only in "bonds." The core idea is the pooling of underlying loans to municipalities for purposes of forming portfolios and, thus, enjoying the associated economies of scale and risk diversification.

A bond bank is a financial intermediary, and must be distinguished from government agency loan programs. Financial intermediaries are entities that themselves are financed in the credit markets. That is, they sell their own securities in competition with other credit demanders. This distinguishes them from other governmental financial entities, such as donor-endowed municipal development funds, that on-lend funds not procured in the capital markets. Bond banks are conduits to the markets. The other entities are substitutes for markets. For this reason, among others, a bond bank can help build local credit markets.

Bond banks can act as a convenient point at which to provide credit enhancements and inducements to borrow. This aspect, however, must be approached gingerly because of the continuing risk of moral hazard (associated with the use of sovereign guarantees) and the dangers of continuing dependency (if the entity acts in a predatory fashion and monopolizes credit market access). In other words, the bond bank intermediary has the potential to cushion and filter the demands of the credit market and transmute them into something with which the small borrower can more easily live. Ideally, however, the demands of the marketplace and investors are always evident and not totally blunted. The execution of documents, the financial discipline, and continuing reporting are still there for the locality to learn and endure. The municipality dealing with a bond bank does, however, get a better shake in the market and access to the privileges of scale.

A final point is that a bond bank can provide a focal point for both public and private efforts to develop a municipal securities market and to improve financial management practices. This is not an insignificant attribute. New approaches and techniques need advocates willing to invest the time and energy to promote and refine them. A bond bank can perform the "May-Pole" function of providing the on-going institutional interest to develop credit market interest in and capacity for dealing in local government securities.

Evolving Local Government Finance in Macedonia

Mrjor reform of the legal framework for local government in Macedonia is now under way. The principal objective is decentralization of the public sector, with devolution of extensive decision-making authority and financial responsibility to municipalities. A key element of the reform effort is the preparation of a new, omnibus Law on Local Government Finance. This law is expected to provide new revenue sources and other financial powers to municipalities, including reformulating and more precisely defining their powers to borrow.

The available data on current local government financing practices are limited. Nonetheless, the new finance law is expected to greatly expand the service responsibilities and financial resources of Macedonian municipalities. At this time, municipal expenditures (not including those of municipal enterprises) are the equivalent of roughly 1.5 percent of GDP and represent less than 5 percent of all public sector expenditures. These are relatively small ratios, and reflect the high degree of concentration at the national level in the existing system. Municipal revenues under the current structure (3.2 billion Denars in 2000, not including receipts of municipal enterprises) derive about 20 percent from own sources and 80 percent from central government shared taxes and various transfers.

Under reforms currently being considered, the municipal share of all public spending could be as high as 18 percent by 2005, as new programs and means to finance them are put in place.[1] Under these projections, total municipal spending would rise to 14.2 billion Denars in 2005.[2] By that date they would represent 5 per cent of GDP as opposed to the current 1.5 percent of GDP.

At present, the responsibilities assigned to local governments appear to be relatively capital intensive in nature. Municipalities are the recipients of large amounts of categorical grants from the central government for infrastructure purposes. These transfers in 2000 consisted predominantly of categorical grants for economic development, the environment, and roads (these summed to 1.3 billion Denars out of a total of 1.8.billion Denars in national transfers in 2000). These data provide some *prima facia* evidence that indicates capital spending activities have and will continue to loom large in municipal budgets. For example, if 30 percent of the municipal spending projected for 2005 were for capital improvements, that would amount to 4 billion Denars of capital spending. That translates into approximately $60-million U.S. dollars at the exchange rate in November 2001. While a large share of this spending is likely to continue to be financed by categorical grants and own current revenues, a significant portion could be funded by borrowing. And, of course, local borrowing could be used to accelerate the pace of construction, were the grant payments to be used to stimulate local contributions that in turn might be funded by borrowing.

Furthermore, the structure of government indicates that there might be a demand for the services of an intermediary such as a bond bank. The local government sector in Macedonia is distinguished by the concentration of population, wealth, and economic activity in Skopje, the nation's capital. Skopje accounts for 28 percent of the population, about 30 percent of the municipal administrative budgets, and nearly 90 percent of VAT collections in the country.[3] It seems fair to presume that governments elsewhere in the country are likely to find access to banking services and credit markets more of a barrier than Skopje.

Table 1 shows the distribution of municipalities in Macedonia by size of population. As a small and compact country, with a population only slightly more than 2 million, Macedonia resembles many U.S. states. That is, there is a dominant central city complex and a number of smaller, urban and rural jurisdictions that individually vary greatly in size, but all of which are relatively small compared with the capital city metropolis.

[1] Based on information provided by advisors with the USAID Local Government Reform Project.

[2] This assumes that the proposed local government finance law is enacted substantially as outlined and that newly devolved functions are financed by new categorical grant programs.

[3] It might be noted that tax collections reflect not only the relative size of bases of wealth and activity, but varying levels of enforcement and compliance as well.

TABLE 1

NUMBER OF MACEDONIAN MUNICIPALITIES BY POPULATION SIZE

Size (000s)	0 - 5.0*	5.1 – 25.0	25.1 - 50.0	50.1 – 100.0	0ver 100.0
Number	51	52	9	11	2

***Of the 51 municipalities with populations under 5,000, only 4 are under 1,000 popu lation.**

The basic data provide some evidence that a bond bank in Macedonia might fill a gap. The country exhibits a considerable number of small, but not miniscule, potential municipal borrowers outisde of Skopje. There could be substantial demand for credit financing of small projects. Also, as is discussed next, there is a potential development role to play.

Developmental Role in the Financial Markets

An additional area in which a bond bank's operation might help meet developmental goals is in the financial markets themselves. The existing credit and capital markets in the country are also small. There are 17 commercial banks and 8 investment (brokerage) houses, 6 of which are subsidiaries of the banks. Total listings on the stock exchange consist of one government bond issue and one private company. All trading is done in the third market of unlisted securities. (Such securities are registered and trades are reported.) In short, the financial markets are completely dominated by the commercial banking system, a characteristic found in most developing countries. At this stage, the growth of non-bank institutional investors is only beginning. For those that already exist, there is little in which to invest denominated in Denars.

Macedonia's credit market is dominated by the national bank bills and notes and the national government bond issue that is listed on the stock exchange. Aside from the bond issue, debt securities are all of short maturity, generally 6 months to two years.[4] The majority of trading in the credit market is overnight trading among the banks. The spread between savings-certificate rates of 8–10 percent (as a proxy for short-term capital cost) and prime commercial loan rates of 18–20 percent generally averages about 10 percentage points.[5]

Investors, wary of devaluation, generally prefer to place their savings in hard currencies, especially the German D-mark. Although development of domestic credit and debt markets is not the primary objective of a municipal bond bank, the potential for a significant contribution exists. Adding to the developmental mix is that commercial banks will, beginning in 2002, be able to hold the deposits of municipalities. This should encourage bank interest in municipalities as customers, including potential borrowers. However, interviews indicate a good deal of reticence in lending to municipal governments until they are better understood.

[4] The bond issue is of 10 years maturity and principal is payable serially in Euros in equal installments. Interest is paid semi-annually in Denars with a 2 per cent coupon. [This is from notes and has not been verified.]

[5] Savings certificate interest rates are for 6 months to 2 years. Loans are for 1–2 years but may extend to 5 years. Lower-quality loans carry higher interest rates. Based on interview with Milena Per…inkova, Treasury Division Manager, Kreditna Banka (21 November 2001).

Relevant International Experience

Visitors are often impressed by the large number of U.S. subnational governments that borrow directly in the securities markets each year.

Less well known, but no less impressive, is the large number of smaller local governments that access the credit markets through the use of state-sponsored financial intermediaries.[6] These loan pools, or bond banks, are employed in one form or another in most of the U.S. states and are even seen at the local level, where intermediaries may be formed to finance governments in a sub-state region.

There is no single definition of a bond bank, but the general idea is a financial intermediary that *sells its own securities* and on-lends the proceeds to participating local governments. In the United States, the traditional bond bank is a state-sponsored entity that assists local governments by providing access to the financial markets, along with various forms of direct and indirect assistance. The bank's primary goal is to lower the cost of funds and improve the lending terms for localities. As their use has spread and seasoned, bond banks have evolved to serve as a point at which various forms of credit enhancement have also been applied, increasing the benefit of the pooling concept.

In the U.S., the first bond banks were established about 30 years ago. The objective was to improve the access of small, frequently rural, local-government borrowers to the markets. These types of governments often got little attention from banks and organized dealers and paid relatively high rates of interest when they could find willing lenders. Intergovernmental assistance also played an important role in developing banks and pools. In the late 1980's, the national Clean Water Act created a host of special-purpose state borrowing entities to finance local wastewater projects. The financing worked through the State Revolving Fund (SRF) program sponsored by the Environmental Protection Administration. Many of the state entities are administratively housed in previously existing state bond banks. The SRF program was expanded in 1996 to include federally assisted drinking water projects.[7]

Canada also uses the bond bank mechanism extensively. Provincial governments approve local borrowings and generally require that municipalities borrow through the provincial bond bank. In the U.S., use of the bond bank is voluntary.[8] Other examples exist, such as the INCA Fund in South Africa, which is a combination public/private bond bank. INCA became

[6] The 50 states of the U.S. have a total of 90,000 local governments. Of these, an estimated 60 percent, or 55,000, have the power to borrow. This power is conferred by and varies greatly among the states. The borrowing powers and processes of the states and their subdivisions are not directly regulated by the U.S. federal government, although most transactions are subject to certain provisions of the national securities laws and are affected by the national tax rules.

[7] There is also some use of the concept of federally seeded revolving funds in transportation, which is a heavy recipient of federal aid. The idea marks a continuation of transforming federal recurring grant programs into self-sustaining loan programs.

[8] It is useful to note in passing that the use of bond banks would be more extensive in the U.S. were it not for special provisions in the U.S. tax code that favor investments by commercial banks in small issues and that also favor the temporary investment of proceeds from small issues. Thus, because of the peculiarities of the tax law, the real economies of scale offered by bond banks is somewhat masked.

active when the post-apartite South African government was formed and the governmental structure of the country was radically changed. Essentially, by making its own direct loans to municipalities, which it internally rates and monitors, and selling shares in its portfolio, INCA has taken over "support" for the South African municipal bond market by acting as an intermediary for both domestic and international investors.

Types of Loan Programs

The variety of loan programs a bond bank may pursue is large. Two general categories can be distinguished based on the maturity of the loan: the long-term bond pool and cash-flow financing.

Long-term bond pool

The classic application of the bond bank is in the financing of infrastructure through long-term loans. The mechanics of a long-term bond pool are fairly standard. Typically, a bond bank issues its bonds (or executes a pooled loan) under a master legal indenture and uses the bond proceeds to purchase debt obligations of localities.[9] Bondholders generally are secured by the aggregate of loan repayments from the pool of local borrowers as opposed to those of any one locality, and in many cases will have additional credit enhancement. Because of the diversification offered in the pool, investors generally require lower interest rates than they would if they were purchasing a single obligation from a locality. In addition, the pooling concept provides certain economies of scale by spreading fixed costs of borrowing (for example, credit analysis expenses, legal fees, and document printing) across several borrowers.

Cash flow financing

Local governments can face periodic shortfalls in operating cash flow because of differences in the timing of the streams of revenues and expenditures during the course of the year. The bond bank can be used for cash-flow financing through the issuance of short-term pooled issues that provide localities with interim funding until operating revenues are received. These programs are very similar to long-term bond pools in their pooled structure and ability to exploit economies of scale and pass on interest-rate savings, but they are difference in maturity (generally one year or less) and purpose of issuance. Typically, these short-term issues are secured by the locality's pledge of operating revenues (perhaps with a sequestration of revenues as received) and also by the ability of the bond bank to intercept state aid in the event of nonpayment on the obligation by the locality.[10]

[9] Indenture is simply a contract that lays out the obligations of the borrower with respect to the lender and includes agreements regarding various aspects of the arrangement. The Master Indenture is a means of standardizing this agreement over a period of time and for several transactions, which helps reduce the area of "renegotiation" in each new loan and provides forward looking security to the holders of existing debt.

[10] Bond banks can also assist in lease-purchase equipment financing. Vendor financing or conventional debt financing for relatively small equipment purchases can be expensive for small governments, while up-front purchases deplete needed cash reserves. In the United States, bond banks have acted as placement agent for the underlying loans with one or several banks. The bond bank provides standardized loan and security documentation

Types of Assistance and Enhancements

The bond bank realizes a variety of economies of scale and efficiencies in operation. It may also serve as a vehicle for various forms of operating assistance and credit enhancement provided by the state to improve the terms and conditions available to local governments generally or for specific areas of activity. Below is a menu of the forms of assistance that have been made available in conjunction with bond bank programs.

Payment of costs of issuance and funding debt-service reserve

Several bond banks in the U.S. pay all or a portion of the costs of issuance on behalf of the participating local governments and initially fund the debt-service reserve requirement for bond bank issues on behalf of local issuers.[11] The sponsoring state government may pay a portion of or all of the costs of issuance for local borrowers.[12] Many bond banks have covered this subsidy through interest earnings generated by bond bank reserves and investment balances. Contribution of funds to finance the debt-service-reserve-fund requirement for bond issues rather than doing so by issuing additional bonds to fund this requirement reduces the effective interest cost for borrowers. Sponsoring governments may also partially cover bond-insurance premiums on behalf of local borrowers.

Revolving-loan programs

Bond banks may offer revolving loan funds.[13] These banks make loans (usually, subsidized) to local borrowers and the ensuing loan repayments are then re-lent to other issuers over time. Thus, moneys in the loan fund constantly "revolve," or are re-cycled to new projects. The assistance may enter in several forms but usually has to do with the capitalization of the bank. Bond bank revolving funds have typically been initially capitalized by a state appropriation, or receive a dedicated, on-going revenue stream from the state to support the subsidized program.[14] Such funds can be popular with donors since they embody the notion of sustainability and constitute a "gift that keeps on giving."[15]

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that allows banks to bid on the loans because of their increased comfort with the credit of the local borrower. The loans can be pooled or placed on a stand-alone basis. For example, the Michigan Municipal Bond Authority offers a monthly competitive sale of pooled loans for equipment purchases by local governments.

[11] The debt-service reserve is a special account that is held to meet the contingency of a shortfall in funds for debt service. It is typically funded at the level of the maximum periodic (annual) debt service or 10 percent of the amount of the issue.

[12] Costs of issuance are broadly the professional and financial costs that go into preparing the for the bond issuance. These vary greatly as a percentage of bond proceeds because of the large economies of scale in financial transactions. Thus the subsidy is relatively most important to very small borrowers.

[13] Several of the bond banks administer the SRF revolving funds that are in large part federally funded. However, others have their own revolving programs that are distinct from that program.

[14] Poland created revolving lending funds capitalized by the receipts from national and regional environmental payments. The fund is specifically used to finance environmental improvements and has been the largest source of loan capital to Polish cities.

[15] It should be noted that federal pollution control and drinking water assistance to local governments in the U.S. is now almost exclusively limited to one-time-capital-grant-funded state revolving funds. This approach

Credit enhancements

In addition to covering administrative costs and capital contributions, sponsoring governments can provide additional interest-rate savings to borrowers by pledging some form of "credit enhancement" to bond-bank issues. The creditworthiness and financial viability of senior governments are usually higher than those of local governments, which can result in lower interest rates on bond bank issues when one or more enhancements are employed.

It should be noted that this element of assistance can be controversial and is often bound up in the existence of an explicit or implicit "sovereign guaranty." Local borrowing that has been undertaken with the thought that the sovereign will bail out investors if there are any difficulties has been the source of considerable mischief in some countries. It is the object of considerable concern to international monetary and financial institutions such as the IMF and the World Bank. The nature and advisability of the implied-sovereign-guarantee issue are not discussed here except to say that such a guarantee is not a necessary (or desirable) feature of a bond bank assisting local governments.

"Moral obligation" on debt-service-reserve fund

Bond bank debt issues often include a debt-service-reserve fund (DSR) that is equal to the bank's maximum annual debt service. The fund is available to be drawn upon in case of default on debt service payments by an underlying local-government borrower. In case of a default and a draw on the reserve fund, the bond bank covenants that it (or the appropriate state official) will "request" the legislature to appropriate funds to restore the reserve fund to its required level. This is called a "*moral obligation.*" Investors look to the state as the ultimate credit support for the bank's issue, although investors still face the risk that the legislature will not appropriate funds to replenish the DSR.[16]

A variation of the approach is the *State Appropriation Support.* Under the appropriation approach, bond bank issues are backed by state legislative appropriation of debt service every year (or every two years depending on the state's budget cycle). The annual appropriation pledge of the state mitigates the risk of local borrower defaults, but investors still bear the risk that the legislature will fail to enact the appropriation.

Senior-level guarantee support

In the U.S. and Canada, a few states and most provinces have pledged their full faith and credit (sovereign guaranty) to either the underlying loans to local governments that are purchased by the bond bank or to the pooled issue sold by the bond bank itself. However, the majority of states *do not pledge* their own full faith and credit because they have statutory limitations on the

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replaced categorical grant programs in the 1980's as the federal government struggled with intense budgetary pressure on domestic programs.

[16] Generally, this *moral-obligation* pledge to replenish the debt service reserve fund results in a credit rating that is one category lower than the state's general obligation rating.

amount of general-obligation debt they can issue, or because they prefer to retain that debt capacity for statewide projects.

Aid-intercept provisions

Many bond banks (and other credit assistance programs) have the statutory authority to intercept state aid to a local government that defaults on its obligations to the bond bank. In other words, the bond bank has the authority to instruct the state to pay directly to the bank state aid scheduled to be paid to the defaulting local government. The intercept mechanism is most powerful as an enhancement of the quality of a bond bank's debt when a local government depends on state aid for a large proportion of its revenues and intercepted payments can be redirected immediately from the bond bank to investors. There is considerable international experience with the use of central-government payments as a means of strengthening local-government creditworthiness, in conjunction with individual loans or through the use of intermediaries.

The ability of localities to pledge to lenders the interception of future state-aid payments in the event of a debt-service deficiency is an important component of many bond-bank operations. However, the security conferred by the pledge depends on the design and predictability of the assistance program. The size and pace of future aid payments, even if constitutionally mandated, will likely depend on the future economic, financial, and political position of the state. For this reason, state aid payments, which are almost always subject to annual appropriation, are not viewed as having the same dependability as a direct pledge of the state's support. Moreover, the ability rapidly to intercept payments in advance of a bond bank's debt service payment dates to avoid a default has never been tested in some states. Nonetheless, as an additional source of pledgeable funds to secure debt, the intercept of state aid can be a substantial source of added security, especially in states where state aid has a long-term track record for payment and is a large part of local government revenues.

In the United States, the high proportion of local revenues accounted for by state aid for primary and secondary education have made this an area that is particularly well suited to the use of intercepts. Local education bonds, independent of the size of the borrower, as a result of the widespread use of the intercept security, are seen as the safest securities in the U.S. bond markets next to those of the federal government. They also carry the lowest interest rates.

International experience with use of the intercept pledge is growing and generally seen as good. National-local-government loan and bond programs involving the pledge of intergovernmental revenues and the intercept mechanisms have been used in Columbia and the Philippines. In the latter country, through 2000, six bond issues had been floated that were secured by the use of the intercept. The issues also carried domestic bond insurance.

Prudential Standards and Coverage

It is important in considering bond banks to understand that, although they can improve market access, reduce costs, and provide their own enhancements, the underlying creditworthiness of the local government is fundamental to the security. There is an assumption, therefore, that the borrowing locality will have either its own stable and sufficient revenues to repay debt or will be able to pledge intergovernmental payments. Debt service must be a regular and sustainable part of its budget and there must be sufficient margins to afford comfort to creditors, including the bond bank.

Local government debt issuance is governed by laws that define required procedures, allowable purposes and instruments, and acceptable forms of security. These laws also place limitations on the amount of debt that can be outstanding or debt service payable in any year.[17] Such limitations are usually expressed as a ratio of debt or debt service to total available revenues or as a percentage of total expenditure. In addition, lenders (including the bond bank) may impose additional requirements to improve the credit posture. For example, there may be a requirement that, in order to secure a loan, revenues from a particular source must be some multiple of debt service. In the Philippines, for example, the maximum proportion of intergovernmental payments that may be pledged to debt service is set at 20 percent. In other words, interceptible intergovernmental payments must be at least five times the amount of debt service. The higher the likelihood future aid programs and their payments will be subject to unpredictable variation, the higher the required coverage factor.

Basic Financial Framework

The schematic in Figure A illustrates the basic framework of the bond bank. Borrowers place their obligations with the bond bank, which in turn effectively bundles them together and sells them to the ultimate investors (or lenders, in the case of a bank loan). The bond bank is selling shares in its portfolio of loans as opposed to selling participations in the individual loans and this combining-function is evidenced by its issuing its own secretaries.

As drawn in Figure A, as part of the loan contract, municipal borrowers typically set aside reserves (debt service reserves, or DSR). Although the borrowers have pledged future revenues, these may for any number of reasons be subject to interruption or delay. Therefore, the DSR's act as liquidity to cover any gaps.[18] By the same token, the bond bank itself typically maintains a DSR. The two levels of reserves (underlying borrower and bond bank), when combined, can effectively represent a year or more of funded debt service needs, depending on the design.[19]

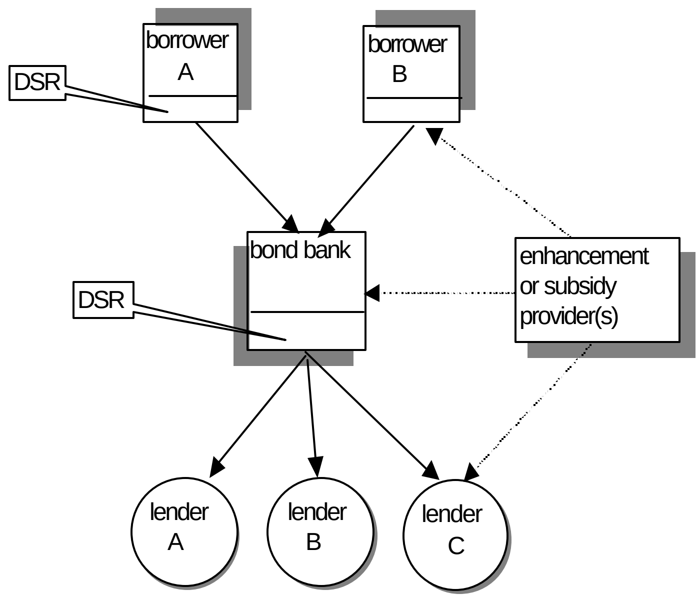
[17] In Macedonia, these provisions are found in Chapter XI, "Municipal Borrowing," of the discussion draft of the Law on Local Government Finance.

[18] While the desire is to spare too much detail, the DSRs are invested in interest bearing accounts and typically are taken as a first appropriation in any budget. They are usually held at the maximum level of debt service.

[19] The discussion assumes a long–term loan structure, with serial maturities of principal. Short-term loans do not have reserves but can have a mandatory setting aside of the pledged revenues when they are received (a form of interception).

FIGURE A

BASIC RELATIONSHIPS: Borrowers, Bond Bank, Enhancer, and Investors



The role of the bond bank is to sell shares in its portfolio to investors. The portfolio represents a diversification of risk for the investor without the toil and cost of holding the underlying small loans. It also affords diversification and liquidity to small investors that otherwise might need to have small holdings of underlying small loans. Note that any enhancements, public or private, can go to the borrowers, the bond bank, or the investors.

Variations on the Design of the Bond Bank

The schematic in Figure B illustrates what could be the relationship between the loan assembly and sponsorship activities of a state-sponsored bond bank entity (FUND) and a commercial bank, with the latter acting as the funds administrator and, as shown, as the securities issuer.[20] The FUND would solicit and receive the loan applications from the would-be borrowers and would conduct the document screening activities. Part of the application would be an assignment of any pledgeable collateral including an assignment of some portion of future state payments. (See discussion of prudential limitation below.)

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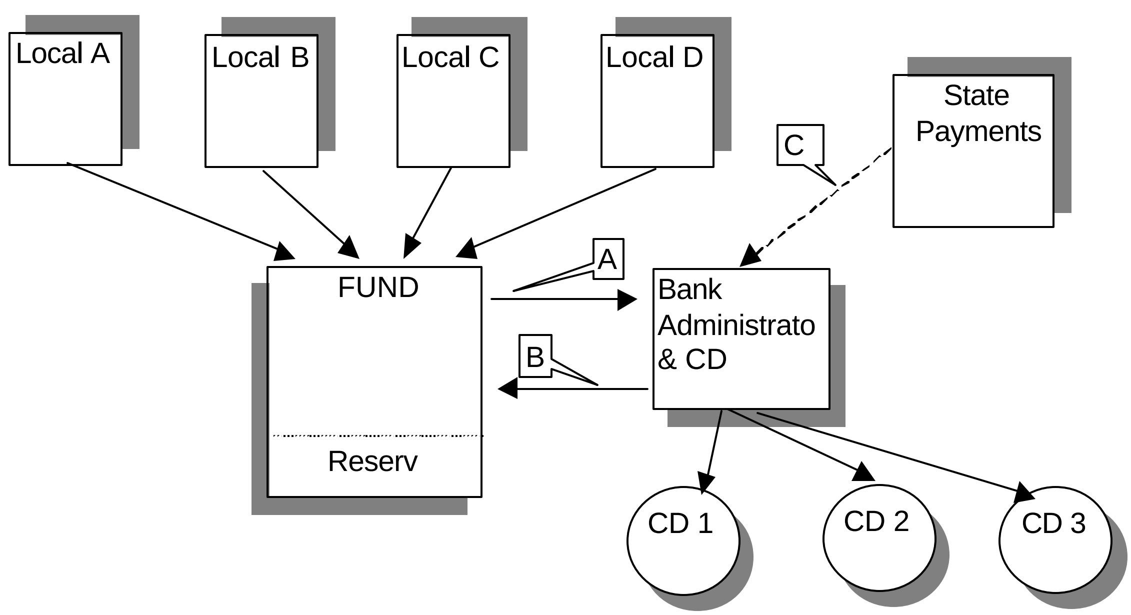
AND ISSUER OF



[20] The entity could have a variety of corporate designs. A state-sponsored entity might be useful in (a) getting donor aid for the reserve fund and (b) for exercise of the intercept provisions. The Bank itself might be largely managed by a commercial bank under a contract with the state. In any event, it is very desirable that it be operationally independent and focused.

FIGURE B

A two-step approach to the lending process would be possible.[21] First, on the basis that the loan had been approved, the commercial bank could make a direct short-term loan to a municipality pending the issuance of the certificate of deposit (CD) security.[22] Second, as is shown in the diagram, when a reasonable number of municipal borrowers had been collected, the bank could issue a CD secured against the obligations of the pool of borrowers. Step [A] and step [B] illustrate the passing of the approved loan documents to the bank and the payment of funds over to the FUND for distribution to the localities.

Several levels of security are possible in the case illustrated above. First, there is the underlying obligation of the local unit and whatever acceptable collateral it might be able to provide. It is commonplace, for example, to require a local government to make its first appropriation to the payment of debt service and to fund its debt-service one year in advance.[23] In addition, there is the assignment by the local government of future state payments to the locality that might be available.

For example, general intergovernmental payments and/or certain proportions of categorical aid payments might be pledged and subject to interception in satisfaction of the debt service were a particular local unit to be late or deficient in making debt-service payments (or funding its own debt-service reserve). This is illustrated by step [C] in the diagram whereby the national government would pay over the needed funds either to the FUND (or directly to the commercial bank) depending on the structure used.

In addition, the FUND would have a reserve fund that would be available to meet any immediate shortfalls or delays in payment. A temporary lapse would be covered by drawing down on the reserve. The reserve would then be replenished by payments from the intercept (as noted below). The reserve would serve the added purpose of creating a source of earnings that could be used to cover initial administrative costs. The FUND would charge borrowers a fee (say, ½ percent of principal) that would be taken out of loan proceeds to reimburse expenses and restore the reserve. The creation of the reserve is a possible contribution by a donor (capital grant) that would be dedicated to this particular purpose. The attraction would be the sustainability of the donation.

Were the commercial bank to offer securities in the form of CDs, it might do so with the certificates carrying either their own bank guarantee or perhaps "without recourse." (This is a matter of the legal treatment, as well as the cost of any added enhancement provided by the bank.) As noted, an attraction to the bank is in procuring depository relationships and gaining familiarity with the sector.

[21] This variant is common in the U.S. Once the bond bank-loan application is approved, the bank can make a loan and then be "taken out" when the bonds are sold.

[22] For purposes of illustration, a CD is used as the market borrowing-instrument. One reason is that the CD, a bank obligation, does not need to be registered with the Securities Commission. The CD would be a "tied deposit" the proceeds of which would be used to fund the municipal loan. This structure, used on occasion in the U.S., might facilitate various credit enhancements.

[23] Short-term loans will differ in this reserve requirement. But the nearness of repayment lessens the risk.

Yet another level of security is possible if the FUND and or the CD securities themselves were to be eligible for enhancement by USAID's Development Credit Authority (DCA) program. The purpose of the DCA program is to use credit enhancements as a means to augment and encourage the mobilization of local credit resources. A common provision is a standby loan agreement or letter of credit for up to 50 percent of qualifying loans made by private sector entities. Repayment of any loan and fee payments can be made in the local currency. The mechanics and cost effectiveness depend on the details of the enhancement design. However, there is the potential to create a very strong security with the elements of a U.S. guarantee, at least in part. The process of examination and approval by U.S. authorities for such a guarantee would also lend credibility to the program.

There are several potential benefits to the use of the FUND administered in tandem with a bank. First, were the FUND itself to be established as a special-purpose entity, this should encourage independence in the assessment of loans and provide some assurance to the bank. Experience gained in the early assembly of borrowers and analysis of information should hone skills for future lending activity. Second, a market-oriented fund would expose the local borrowers to realistic interest rates that are charged in the Macedonian market. While there might be "buying down" of the interest rate in some cases, the exposure to the market rates and investor demands for information would be healthy for the would-be borrowers. As investors and the bank gain experience with local government, larger units might choose to borrow directly from the markets or banks and avoid certain fees.

Organization and Administration

Most bond banks in the United States are financially self-supporting. In other words, they are not reliant on government appropriations. Self-supporting bond banks may have revenues from a variety of sources, but the most common means of support of operations is from fees charged to local borrowers or from earnings on invested reserves. Bond banks can levy lump-sum fees at bond closing (funded from proceeds) or may charge an annual fee based on outstanding loan amount or marked-up interest rates. Retention of interest earnings on reserves and bond funds can also create significant cash reserves and can be used to fund operations and, perhaps, to give subsidies or services to local governments.

Most bond banks in the U.S. were created by an act of a state legislature and generally have no independent taxing power. Organizationally, they are located within a line department or operate as a separate authority. In either case, they tend to be compact. Of the bond banks recently studied in the United States, the size of staff ranged from 1 and ½ persons (New Mexico) to 10 persons (Michigan). For most states, the staff numbers 2 or 3 persons, often working part time. The primary staff roles are marketing and managing the process. One or two bond sales a year is the common frequency, each issue representing several (5–15, is an average) underlying loans to local governments. Expert advice in executing the bond sales or bank loans or in managing various funds is hired as needed from market sources.

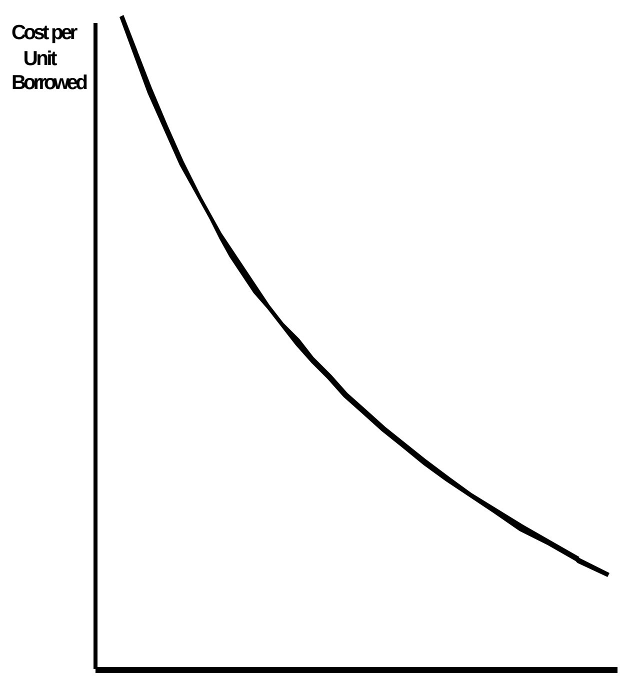
A consequence of the small staff is that costs are relatively low and the bond banks can charge small fees. When a bond bank is part of a larger department, its overhead costs are often largely assumed by the host agency, further reducing the cost to the underlying local governments.

Declining Transactions Costs

An important aspect of the bond bank is its ability to lower the costs of transactions for its participants. There are many examples of how this is accomplished, and the declining unit costs of transactions is a well-documented phenomenon. The curve in Figure C below presents a stylized rendering of the size and unit-cost relationship. The primary reason for the economies is that virtually all the costs of documentation and marketing are essentially fixed. Other economies are possible as well and are particularly pertinent to an economy with a small financial sector with little or no experience lending to local governments. For example, a specialized institution can develop skill and experience in performing credit analysis and in monitoring the financial operations and condition of municipal debtors.[24] The use of standard documentation and repetition of transactions also brings economies to the bank's activities.

FIGURE C

DECLINING COST OF FINANCIAL TRANSACTIONS



[24] For example, with few potential borrowers and small amounts borrowed, there is little likelihood that a private credit rating agency could be established, and use of international agencies would be prohibitively expensive (the typical minimum cost is $15,000 to $20,000 per opinion). The bond bank, by concentrating the access for most municipal borrowers, would enjoy economies of scale and its acceptance of a credit, were it done in credible and independent fashion, would constitute a finding of creditworthiness.

Bond banks can be very spare institutions that hire specialized help on a consulting basis. As discussed earlier, bond banks in the U.S. often have only two or three employees and small budgets. A possible variant would be for a line agency to bid out a contract to a commercial bank to perform virtually all the administrative functions, with an agency representative overseeing the contract and participating in the marketing efforts.